

ORIGINAL



MEMORANDUM

TO: Docket Control

FROM: Steven M. Olea
Director
Utilities Division

EA for SMD

DATE: November 2, 2012

ARIZONA PUBLIC SERVICE COMMISSION
DOCKETED
NOV 2 2012

RE: STAFF REPORT IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR AN ORDER OR ORDERS AUTHORIZING IT TO ISSUE, INCUR, AND AMEND EVIDENCES OF LONG-TERM INDEBTEDNESS, SHORT-TERM INDEBTEDNESS, AND OTHER LONG-TERM SECURITIES, TO MANAGE INTEREST RATE RISK, TO EXECUTE NEW SECURITY INSTRUMENTS TO SECURE ANY SUCH INDEBTEDNESS OR OTHER LONG-TERM SECURITIES, AND FOR DECLARATORY ORDER CONCERNING VARIABLE INTEREST ENTITIES (DOCKET NO. E-01345A-11-0423)

Attached is the Staff Report for Arizona Public Service Company's application requesting authorization for various financing transactions and a declaratory order concerning variable interest entities.

Staff recommends authorization to incur indebtedness not to exceed to \$5.1 billion (with no more than \$750 million as variable debt) through 2016, the use of certain financial derivative securities to manage interest rate risk and exposure, and of the Company's requested declaratory order concerning variable interest entities. Staff further recommends denial of authorization to issue other long-term securities.

Any party who wishes may file comments to the Staff Report with the Commission's Docket Control by 4:00 p.m. on or before November 9, 2012.

SMO:JAC:kdh

Originator: John A. Cassidy

Attachment: Original and fourteen copies

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ARIZONA PUBLIC SERVICE COMMISSION
DOCKET CONTROL

Service List for: Arizona Public Service Company
Docket No. E-01345A-11-0423

Mr. Thomas Mumaw
400 N. Fifth Street
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Phoenix, Arizona 85004

**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

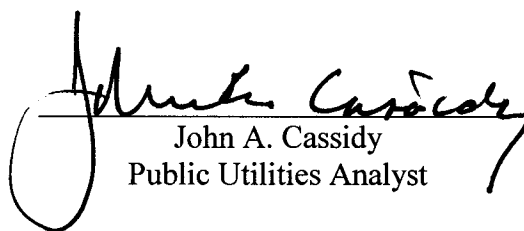
**ARIZONA PUBLIC SERVICE COMPANY
DOCKET NO. E-01345A-11-0423**

**APPLICATION FOR A FINANCING ORDER
AUTHORIZING VARIOUS FINANCING TRANSACTIONS**


NOVEMBER 2, 2012

STAFF ACKNOWLEDGMENT

The Staff Report for Arizona Public Service Company, Docket No. E-01345A-11-0423, is the responsibility of the Staff members listed below. John A. Cassidy was responsible for the financial review and analysis. Prem Bahl was responsible for the engineering review and analysis.



John A. Cassidy
Public Utilities Analyst



Prem Bahl
Utilities Engineer – Electrical

**EXECUTIVE SUMMARY
ARIZONA PUBLIC SERVICE COMPANY
DOCKET NO. E-01345A-11-0423**

On November 22, 2011, Arizona Public Service Company ("APS" or "Company") filed an application with the Arizona Corporation Commission ("Commission") requesting authorization for various financing transactions.

Staff recommends:

1. Increasing APS' authorized long-term debt threshold to \$5.1 billion subject to the following conditions:
 - (a) common equity represents at least 40 percent of total capital (common equity, preferred stock, long-term debt and short-term debt);
 - (b) debt service coverage ratio ("DSC") is equal to or greater than 2.0;
 - (c) variable interest debt should not exceed \$750 million; and
 - (d) APS not having entered into any agreement/contract for any financial derivative security or similar instrument other than those authorized by the Commission, and establishing that violation of this condition shall result in immediate expiration of this general authorization to issue long-term indebtedness (This provision is not intended to place any restriction on hedging activities pertaining to energy procurement).
2. That the authorizations to incur long-term debt, and short-term debt obligations provided in this proceeding replace all existing authorizations and that all existing authorizations expire upon the effective date of the authorizations provided in this proceeding.
3. Authorization for APS to incur short-term debt not to exceed \$500 million above 7 percent of total capital provided that the excess over 7 percent of total capital shall be used solely for costs relating to natural gas or power purchases and as long as APS has an authorized adjustor mechanism for recovery of these kinds of costs.
4. That short-term debt in excess of 7 percent of total capital, used solely for costs relating to natural gas or power purchases, not be applied toward APS' long-term debt threshold even when the amount remains outstanding for more than 12 months.
5. Authorization for APS to redeem, refinance, refund, renew, reissue, roll-over, repay, and re-borrow from time to time the long-term debt and short-term debt in (1) and (3) above.
6. That the short-term and long-term debt levels authorized in this proceeding expire on December 31, 2016.

7. Authorization for APS to (1) conduct the activities enumerated in the application that are necessary to secure and maintain debt, (2) to determine the form of security (except as otherwise established in the Order), if any, for the continuing long-term debt and continuing short-term debt, execute and deliver the security instruments, and establish and amend the terms and provisions of the security instruments, as may be deemed appropriate by APS in connection with the continuing long-term debt and continuing short-term debt.
8. Denial of APS' request to issue Other Long-Term Securities..
9. Direct APS not to enter into any derivative financial instrument that effectively converts fixed cost long-term debt in (1) above to floating/variable cost debt;
10. Direct that for purposes of calculating the \$750 million aggregate limit on the outstanding balance of floating/variable cost rate long-term debt, in the event that the Commission authorizes issuance of derivative financial instruments that effectively convert fixed cost rate debt to floating cost rate debt, the converted debt shall be considered floating cost rate debt;
11. Authorize APS to enter into derivative financial instruments that convert floating cost long-term securities to long-term fixed cost securities. For purposes of calculating the \$750 million aggregate limit on the outstanding balance of floating/variable cost rate debt, any floating cost security effectively converted to a fixed cost security by issuance of a financial derivative instrument or any other means shall be deemed a fixed cost security;
12. Find that it is in the public interest for the Commission to control the use by APS of interest rate swap agreements, U.S. Treasury rate-lock agreements, derivative financial securities and similar instruments;
13. Require APS to file confirmation with the Commission Docket Control Center certifying that it has established an appropriate management policy/system of internal controls formally approved by APS' Board of Directors designed to govern such trading within the organization prior to initiation of trading activity in financial derivative securities or similar contracts to manage interest rate risk and/or exposure;
14. Find that any authorization granted APS to engage in financial derivative securities or similar contracts to manage interest rate risk and/or exposure should specifically exclude use of such authorization for speculative purposes;
15. Authorize APS to issue forward-starting swaps based on LIBOR or U.S. Treasuries and U.S. Treasury rate-locks for the purpose of hedging changes in interest rates up to 18 months in advance of planned issuances of fixed-rate taxable long-term debt having final maturity of five years or longer;

16. Deny APS' request to amortize gains or losses associated with pre-issuance interest rate hedging transactions over the life of the new debt issuance to which they relate;
17. Order that the authorizations to incur short-term and long-term debt obligations in this case shall replace all existing authorizations for the incurrence of short-term and long-term debt provided for in Decision No. 69947. that those authorizations expire upon the effective date of an Order in this case, and that all existing obligations incurred under lawful authorizations shall remain valid;
18. That on each occasion when APS enters into a new long-term debt agreement that APS file with the Commission's Docket Control Center within 90 days of the completion of the transaction a description of the transaction and a demonstration that the rates and terms were consistent with those generally available to comparable entities at the time and provide the Utility Division Compliance Section a copy of the relevant agreements; and
19. Approval of APS' request for a declaratory order confirming that all impacts of the consolidation with APS for accounting purposes of the Palo Verde Sale Leaseback Lessor Trusts as Variable Interest Entities ("VIEs") are to be excluded for the purpose of calculating Common Equity Test and DSC, and similarly excluded from calculating any dollar limits placed on authorizations for long-term debt and short-term debt.

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Introduction

On November 22, 2011, Arizona Public Service Company (“APS” or “Company”) filed a finance application with the Arizona Corporation Commission (“Commission”). In the application APS requests authorization for various financing transactions relating to its long-term and short-term indebtedness, the authority to manage interest rate risk and exposure by issuing financial derivative securities and a declaratory order confirming that all impacts of the consolidation with APS for accounting purposes of the Palo Verde Sale Leaseback Lessor Trusts as Variable Interest Entities (“VIEs”) be excluded for purposes of the Common Equity Test and Debt Service Coverage Ratio (“DSC”), and similarly excluded from calculations of the threshold dollar limits established for continuing long-term debt, other long-term securities and continuing short-term debt.

Notice

On October 23, 2012, APS filed an affidavit of publication verifying public notice of its financing application. APS published notice of its financing application in *The Arizona Republic* on October 16, 2012. The affidavit of publication is attached along with a copy of the Notice.

Compliance

As of October 23, 2012, a check of the Compliance Division database indicates that APS is current with its compliance filings, with several items received from APS pending review by Staff.

Background

APS is a wholly owned subsidiary of the Pinnacle West Capital Corporation (“Pinnacle West”). Both APS and its parent are Arizona corporations whose principal place of business is in Phoenix, Arizona. Pinnacle West has not joined APS in this application.¹ In Decision No. 55017,² the Commission established APS’ long-term debt threshold at \$2,698,917,000. In Decision No. 65796,³ the Commission authorized APS to issue an additional \$500 million in long-term debt for purposes of repaying Pinnacle West for monies borrowed to finance construction of electric utility plant. Decision No. 65796 further stipulated that this \$500 million debt authorization was not to be counted against the limitation placed on APS’ long-term indebtedness, thus providing total long-term debt authorization of \$3,198,917,000.⁴ In its last financing case,⁵ APS requested an increase in long-term indebtedness to a level of \$4,200,000,000, inclusive of the \$500 million specific debt authorization noted above, and additionally, authorization for short-term indebtedness equal to seven percent of total

¹ Page 4 of Application, footnote one.

² Dated May 6, 1986.

³ Dated April 4, 2003.

⁴ \$2,698,917,000 general debt authorization and \$500 million specific debt authorization.

⁵ Docket No. E-01345A-06-0779, filed December 15, 2006.

capitalization, plus \$500 million. In Decision No. 69947,⁶ the Commission authorized APS' current long-term debt threshold of \$4,200,000,000, and short-term debt threshold of seven percent of total capital plus \$500,000,000.

Description and Terms of Proposed Financing

Long-Term Debt and Other Long-Term Securities

APS now seeks authorization for a \$1.3 billion increase to its long-term debt threshold, from the \$4.2 billion authorized in Decision No. 69947 to a level of \$5.5 billion. Additionally, as part of such authorization, APS requests that it be allowed to issue other types of securities providing long-term capital financing including, without limitation, preferred stock, trust preferred securities, or other forms of so-called "hybrid" capital securities ("Other Long-Term Securities").

APS further requests that such authorization permit it to redeem, refinance, refund, renew, reissue, roll-over, repay, re-price and re-borrow from time to time any outstanding long-term debt or other long-term securities, to incur or sell or issue any additional long-term debt or other long-term securities, and to establish, amend, or revise any terms or provisions of or relating to any long-term debt or other long-term securities without further Commission approval, as long as the sum of its outstanding long-term indebtedness (including current maturities thereof) ("Continuing Long-Term Debt") and Other Long-Term Securities does not exceed \$5.5 billion for any period of more than thirty days. APS also requests that any security issued to support, or otherwise issued in connection with, an Other Long-Term Security not be counted against the debt threshold to avoid duplication with the underlying Other Long-Term Security which is a component charged against the threshold.

As noted in the application,⁷ "hybrid" securities have attributes of both debt and equity, thereby making them difficult to classify as being one or the other form of long-term financing. Accordingly, for purposes of the Common Equity Test and DSC, APS requests authorization to classify such other long-term securities in a manner consistent with the way they are treated by at least one of the three major credit rating agencies.⁸ For example, if a rating agency were to classify preferred stock as 50 percent debt and 50 percent equity, APS asks that it be allowed to apply that same ratio to the proceeds received from any preferred stock it may prospectively issue, treating one-half (50%) as debt capital and the other half (50%) as equity capital. As further noted in the application, APS currently has the ability to issue only long-term debt securities, with equity capital coming either from ongoing earnings or equity infusions from its parent. Because these two types of capital represent the two ends of the capital security continuum (debt being the cheapest and equity the most costly), APS states that authorization to issue Other Long-term Securities will provide capital from more sources, thereby allowing the

⁶ Dated October 30, 2007.

⁷ Page 4 of Application, footnote two.

⁸ Standard & Poor's, Moody's and Fitch.

Company to more effectively manage its capital structure to achieve a reasonable weighted average cost of capital.

Short Term Debt

Pursuant to A.R.S. §40-302(D), APS may issue short-term debt in amounts up to 7 percent of total capitalization without Commission approval. Decision No. 69947 authorized APS to issue Continuing Short-Term Debt (i.e., all short-term debt excluding current maturities of long-term debt) by an additional \$500 million above this statutory level, provided that (1) the excess above 7 percent of total capital be used solely for costs relating to purchases of natural gas and power, and (2) APS have a Commission authorized adjustor mechanism in place for recovery of natural gas or power purchases. Decision No. 69947 further stipulated that short-term debt in excess of 7 percent of total capital used solely for costs relating to natural gas or power purchases not be applied toward APS' long-term debt threshold even if said short-term debt is outstanding for more than 12 months. In the application, APS requests a continuation of the short-term debt authorization granted the Company in Decision No. 69947.

APS further requests that such authorization allow the Company to redeem, refinance, refund, renew, reissue, roll-over, repay, re-price and re-borrow from time to time any outstanding short-term debt, to incur or sell or issue any additional short-term debt, and to establish, amend, or revise any terms or provisions of or relating to any short-term debt without further Commission approval, as long as total short-term debt does not exceed the sum of (1) 7 percent of APS' total capitalization and (2) an additional \$500 million.

Terms and Conditions of Long-Term Debt and Other Long-Term Securities

APS requests Commission authorization to determine the form of security, if any, for the Continuing Long-Term Debt, Other Long-Term Securities and Continuing Short-Term Debt, to execute and deliver one or more Security Instruments (any mortgage and deed of trust or similar instrument that establishes a lien) in connection with Continuing Long-Term Debt, Other Long-Term Securities and Continuing Short-Term Debt; and to establish and amend the terms and provisions of such Security Instruments from time to time without further Commission approval.

APS also requests confirmation of all ordering language in Decision No. 69947 unless specifically modified by its application. Decision No. 69947 includes the following provisions: (1) a 40 percent minimum Common Equity Test; (2) a 2.0 DSC requirement; (3) a provision to allow short-term borrowing in excess of seven percent of total capital after the adopted expiration date in certain circumstances; (4) a requirement to file a description of certain long-term debt transactions in Docket Control; (5) a process to address changes in generally accepted accounting principles with unintended consequences as they apply to the Common Equity Test, DSC and debt threshold; (6) a provision to allow Pinnacle West to guarantee APS debt under certain circumstances and for APS to reimburse Pinnacle West for certain costs; and (7) to use the amount of short-term debt in excess of seven percent of total capital only for purchases of

natural gas and power and to condition authorization of the excess on APS having a Commission authorized adjustor mechanism for recovery of these costs.

Manage Interest Rate Risk and Exposure

APS requests Commission authorization to manage interest rate risk and exposure associated with Continuing Long-Term Debt, Other Long-Term Securities and Continuing Short-Term Debt, as the Company deems appropriate based, among other things, on market conditions from time to time. As contemplated in the application, such authority would allow APS to execute and enter into financial derivative instruments such as fixed-to-floating interest rate swaps, floating-to-fixed interest rate swaps, Treasury rate locks, interest rate caps, and forward starting swaps.⁹ As stated in the application, such authorization will allow APS to limit ratepayers' exposure to interest rate volatility and/or achieve lower interest rates. For accounting purposes, APS requests treating any gains or losses associated with pre-issuance interest rate hedging transactions in a manner similar to that of a debt reacquisition, i.e., to amortize them over the life of the new debt issuance to which it relates causing gains (losses) on such hedging transactions to have the effect of reducing (increasing) the effective interest rate on the newly issued debt instrument. APS states that any fixed-to-floating or floating-to-fixed interest rate transactions or interest rate caps would be reflected in the net interest rate of the financing instruments to which those transactions relate.

Declaratory Accounting Order

APS seeks a declaratory order confirming that all impacts of the consolidation with APS for accounting purposes of the Palo Verde Sale Leaseback Lessor Trusts as Variable Interest Entities ("VIEs") are to be excluded, both for purposes of the Common Equity Test and DSC, as well as from the dollar limitations placed on authorizations for Continuing Long-Term Debt, Other Long-Term Securities and Continuing Short-Term Debt. In the application, APS points out that beginning in 2010 a change in Generally Accepted Accounting Principles ("GAAP") now requires the Company to consolidate these entities as debt for financial reporting purposes; this, despite APS having no debt or equity interest in the VIEs, nor exercising any manner of control over them.

Purpose

As stated in the application, APS proposes to use the net proceeds from the issuance of Continuing Long-Term Debt, Other Long-Term Securities and Continuing Short-Term Debt to finance its construction, resource acquisition and maintenance programs; to redeem or retire outstanding securities; to repay or refund other outstanding long-term or short-term debt; and to meet certain of the Company's working capital and other cash requirements.

⁹ In response to Staff data request 1.8, the Company identified, without further explanation, Libor Swaps, Forward-Starting Libor Swaps, Treasury Locks and Interest Rate Caps as the types of financial derivative instruments it presently anticipates using to manage interest rate risk.

Appendix “A” of the Company’s application presents a schedule showing the dollar amounts of external financing needed to fund the Company’s projected capital budget over the 6-year period, 2012-2017.¹⁰ As contemplated, APS plans to fund its capital budget using a combination of internally generated funds, and external financing provided by both equity capital and long-term debt capital, with the amount of long-term debt needed as of December 31, 2017, projected to be \$5.522 billion, an amount roughly equivalent to the \$5.5 billion amount requested.

Engineering Analysis

APS’ construction work plan for 2012 through 2016 includes \$3.47 billion for generation, \$740 million for transmission, \$228 million for sub-transmission, \$1.35 billion for distribution and \$113 million for underground cable projects. Staff concludes that the Company’s proposed capital expenditures are appropriate to meet the projected needs of APS’ existing and new customers and to ensure system reliability. In summary, APS’ capital improvement plan is appropriate and the expenditure levels associated with the projects proposed by the Company appear to be reasonable.¹¹ However, Staff makes no determination regarding any ratemaking treatment pertaining to these projects nor should any ratemaking treatment be inferred (see Attachment A for more detail).

Financial Analysis

Long-term and Short-term Debt Thresholds

In response to Staff data request 1.2, APS provided Staff with audited financial statements for its most recent fiscal year. As of December 31, 2011, APS’ capital structure consisted of 54.4 percent equity (\$3,943,007,000), and 45.6 percent long-term debt (\$3,305,942,000). APS had no short-term debt outstanding at December 31, 2011.

A pro-forma capital structure reflecting combined issuance of Continuing Long-Term Debt and Other Long-Term Securities as debt in the \$5.5 billion threshold amount requested by APS consists of 41.8 percent equity and 58.2 percent long-term debt.

In the application, APS requests an increase to its \$4.2 billion long-term debt threshold to a \$5.5 billion combined Continuing Long-Term Debt and Other Long-Term Securities threshold, and a continuation of the short-term debt threshold authorized in Decision No. 69947. That is, APS seeks a general authorization to take on new debt and issue other long-term securities in unspecified amounts over time. The nature of the Company’s proposed authorizations require establishment of financial parameters and conditions to apply in advance to these proposed

¹⁰ The schedule appearing in Appendix A of the application is titled, “Projected APS Outstanding Long-Term Debt.”

¹¹ In data request Staff 3.1, the Company was asked to provide detail to support its proposed capital expenditures for the six year period, 2012-2017. In response, APS provided a detailed breakout for only those capital projects contemplated in years 2012-2016, and acknowledged that no such detail was available for 2017. Accordingly, Staff confined its engineering analysis only to those capital projects proposed for the years 2012 through 2016.

borrowings to prevent APS from taking on an excessive amount of debt. As thresholds are on-going in nature, the financial parameters employed as conditions for allowing any future borrowings must, likewise, be on-going in nature. DSC¹² is an effective parameter for this purpose as it demonstrates the ability to service debt in all aspects and is dynamic (i.e., it gives recognition to changes in operating results). Equity-to-total capitalization is also appropriate to show a balance sheet perspective of financial leverage and risk. Accordingly, Staff concludes that DSC and equity-to-total capitalization parameters which were adopted in Decision No. 69947 are effective for placing conditions on debt issuances within a framework of a threshold authorization and that adoption of these conditional parameters going forward is appropriate.

Staff data request 3.1 asked APS for a breakout of the specific projects contemplated in its 2012-2017 projected capital budget. In response, APS provided detail on only those projects planned covering the 5-year period, 2012-2016. In the narrative portion of the Company's response, APS indicated that no detailed breakout of projects had been made for the year 2017, and that for purposes of the application the level of capital expenditures for 2017 was assumed at the same level as 2016. As presented in Appendix "A" of the application, the projected long-term debt needed to fund APS' capital budget through December 31, 2016, is \$5.097 billion. Arizona Revised Statutes § 40-302 requires a utility to secure Commission authorization for "the purposes to which the issuance or proceeds thereof are to be applied" before issuing indebtedness. Since APS has not provided support for its proposed capital improvements for 2017, Staff concludes that any authorizations granted in this proceeding should exclude the \$425 million incremental Continuing Long-Term Debt and Other Long-Term Securities authorization requested for 2017 over the amount for 2016. Therefore, a \$5.1 billion threshold is appropriate.

APS seeks a continuation of its current authorized short-term debt threshold, a figure equal to 7 percent of total capitalization plus \$500 million. APS uses short-term borrowings to finance the purchase of natural gas for generation of electricity and for the purchase of power from other providers. Fuel and power purchases are critical activities for meeting electric load requirements, and prudent procurement practices may be accompanied by large short-term capital requirements. Accordingly, Staff concludes that continuation of the authorization for short-term indebtedness in excess of 7 percent is appropriate, as it facilitates APS' continued ability to purchase natural gas or power, as needed, and to recover the associated costs over what is anticipated to be the short term via a purchased power adjustor mechanism.

Approval of the requested authorizations for long-term and short-term indebtedness will provide considerable financial flexibility to APS, allowing the Company access to the capital markets quickly, as needed, without first seeking Commission authority. Approval of these proposed debt limits will further provide APS the ability to take advantage of favorable conditions in the financial markets, timing the issuance of new securities to obtain better offering

¹² DSC represents the number of times internally generated cash will cover required principal and interest payment on short-term and long-term debt. A DSC greater than 1.0 indicates that operating cash flow is sufficient to cover debt obligations. A DSC less than 1.0 means that debt service obligations cannot be met by cash generated from operations and that another source of funds is needed to avoid default. As of December 31, 2011, APS had a DSC of 1.73.

prices, terms and conditions. Approval to exceed the short-term debt limitation of 7 percent of capitalization for purposes related to the purchase of natural gas or power would facilitate APS' effective management of purchases necessary to meeting electric load requirements. Accordingly, an authorization to increase APS' long-term debt threshold and continuation of its current short-term debt threshold is appropriate, provided that such authorization includes a debt expiration date certain to maintain reasonable oversight of APS' capital financing by compelling it to seek reauthorization. However, as noted above, because APS has not provided detail to support its year 2017 capital budget, Staff concludes that approval of a \$5.1 billion (the year end 2016 projected \$5.097 billion long-term debt requirement, as shown in Appendix A of the application, rounded) threshold is warranted. As a consequence, the appropriate expiration date certain for any newly authorized long-term financing is December 31, 2016, and not the December 31, 2017, date proposed by the Company.

Staff calculated a pro-forma capital structure for APS reflecting \$5.1 billion of Continuing Long-Term Debt, and it consists of approximately 43 percent equity and 57 percent long-term debt.

Other Long-Term Securities

APS requests, as a component of its requested \$5.5 billion threshold, authorization to issue Other Long-Term Securities that provide long-term capital financing including, without limitation, preferred stock, trust preferred securities, or other forms of so-called "hybrid" capital securities.¹³ Such "hybrid" securities have attributes of both debt and equity capital. Accordingly, for purposes of the Common Equity Test and DSC, APS requests authorization to classify such other long-term securities in a manner consistent with the way they are treated by at least one of the three major credit rating agencies.

In response to Staff data request 4.1, the Company notes that two of the three major credit rating agencies (Standard & Poor's and Fitch) treat both preferred stock and trust preferred securities as either 100 percent debt, 100 percent equity, or 50 percent debt/50 percent equity on the debt-equity continuum, while the third rating agency (Moody's) moves in 25 percent increments, treating preferred stock and trust preferred securities as either 50 percent debt/50 percent equity, 25 percent debt/75 percent equity, or 0 percent debt/100 percent equity. In light of the Company's response, granting APS the authority to classify, for purposes of the Common Equity Test and DSC, such Other Long-Term Securities in a manner consistent with the way they are treated by one of the three major credit rating agencies would be inappropriate since the treatment among the rating agencies is inconsistent, thereby allowing APS to choose any of the three. Doing so would also serve to subordinate this Commission's regulatory authority, and has the potential for APS to ignore, entirely, the intrinsic debt attributes of any preferred stock or trust preferred security it may prospectively issue should one of the three credit rating agencies

¹³ In response to Staff data request 5.1, APS stated that the "with limitation" language in the application was meant to avoid preclusion of the issuance of a form of hybrid capital and listed the varieties as: Preferred or Preference Stock; Trust Preferred or Preference Securities; Junior Subordinate Debentures; and Other financing instruments with a brief description for each.

treat such securities as 100 percent equity. In order to simplify the debt versus equity treatment of Other Long-Term Securities and to be cautionary in that distribution, Staff concludes that, if the Commission authorizes issuances of Other Long-Term Securities, these securities should be considered 60 percent (60%) debt and 40 percent (40%) equity.

APS asserts that authorization to issue Other Long-Term Securities and the resulting access to more sources of capital allows it to more effectively manage of its capital structure to achieve a reasonable weighted average cost of capital, achieve ratings objectives, maintain a diverse investor base and maintain access to ready, reliable capital. Although, these are theoretically appealing conclusions, in practice issuance of Other Long-Term Securities represents a relatively small source of capital for utilities and the Company has not provided any specific need to issue these types of securities, nor has the Company proposed any limitation, restriction or other qualification on issuance of these types of securities. Accordingly, Staff concludes that the Company's request is excessive and that a separate financing filing is a more appropriate vehicle for requesting specific authorization for these types of securities than is this general authorization proceeding.

Variable (Floating) Interest Financial Instruments

Financial instruments with floating/variable cost rates present financial risk (a probability of loss) and exposure (a possibility of loss). The Continuing Long-Term Debt and Other Long-Term Securities authorizations requested by APS each represent types of financial securities that can take a form that presents costs that vary due to changes in market conditions such as interest rates. Cost stability is a desirable objective when providing utility service, and adverse impacts from variable costs should be managed to balance the risks of variable costs with the benefits of issuing floating cost financial instruments. Under a multi-year general authority to issue multi-billion dollars in securities, it is prudent to limit the risk and exposure presented by variable cost financial instruments to the Company and its ratepayers. Accordingly, Staff concludes that the aggregate outstanding value of floating cost Continuing Long-Term Debt combined with any Other Long-Term Securities that the Commission may authorize should not exceed \$750 million. For purposes of calculating the aggregate outstanding balance of floating cost financing, any fixed cost security effectively converted to a floating cost security by issuance of a financial derivative instrument or any other means should be deemed a floating cost security.

Manage Interest Rate Risk and Exposure

In response to Staff data request 1.9, APS clarified that it plans to use financial derivatives¹⁴ exclusively for managing risk and exposure associated with fuel and purchased power, monetary exchange fluctuations and changing interest rates, i.e., to manage financial risk and exposure, also referred to as "hedging." In response to Staff data request 5.5, APS further indicated that given the potential consequences of an unauthorized execution of derivative

¹⁴ A financial derivative can be defined as a financial product that derives its value from an underlying asset or liability.

interest rate instruments or the use of proceeds from an otherwise authorized security for an unauthorized purpose, the Company would not be comfortable entering into these instruments without clear authorization from the Commission.

Forward-starting Swaps:

Forward-starting swaps based on London Interbank Offer Rate¹⁵ ("LIBOR") or U.S. Treasuries and U.S. Treasury rate-locks are used to manage risk related to interest rate volatility, and the two are essentially the same in terms of mechanics and economic impact when used as a hedge. These derivative interest rate contracts are typically used by entities planning to issue fixed rate debt at a future date that also desire to mitigate the potential for interest rates to rise before the issuance date. For instance, assume that the interest rate on long-term debt equals LIBOR or the 10-year treasury rate plus a spread. Also assume that Utility A plans to issue a \$100 million, 10-year debt in 12-months, and the 12-month LIBOR forward rate on a 10-year swap is 2.00 percent today. In order to avoid the impact of a potential increase in interest rates, Utility A can buy a 12-month forward-starting swap on a 10-year, \$100 million notional amount from Counterparty B to effectively ensure that the net present value of its cash flows on the debt issued will reflect the 2.00 percent rate regardless of any increase or decrease in interest rates over that 12-month period.

For example, if at the end of the 12-month period when Utility A issues the debt, the current LIBOR rate is 2.25 percent, Utility A will issue the debt at 2.25 percent plus the spread. Utility A's purchase of the forward-starting interest rate swap entitles it to a payment from Counterparty B equal to the net present value of the 25 basis point (2.25 percent – 2.00 percent) increase in the LIBOR interest rate on the \$100 million debt for 10 years.¹⁶ If Utility A amortizes the payment received from Counterparty B over the 10-year term of the debt issuance, the effective annual interest cost is 2.00 percent.

Staff concludes that forward-starting swaps are effective for managing interest rate risk and for assisting management in planning and budgeting for future capital improvement expenditures. Accordingly, authorization of forward-starting swaps is appropriate.

In its application, APS requests authority to amortize any gains or losses associated with pre-issuance interest rate hedging transactions over the life of the issuance to which it relates. Staff concludes that APS has presented no good reason to pre-determine the treatment of these costs outside of a rate case.

Interest Rate Swaps and Variable Interest Debt:

Interest rate swaps are a widely used type of financial derivative. Interest rate swaps provide a good example of the benefits and detriments of using financial derivatives.

¹⁵ LIBOR is the interest rate offered by London banks on deposits made by other banks in the Eurodollar markets.

¹⁶ If the LIBOR interest rate decreases, Utility A is obligated to pay Counterparty B.

An interest rate swap is an agreement between two parties to exchange different streams of interest payments. Typically, one party agrees to pay the other a stream of fixed interest payments in exchange for a stream of variable interest payments from the other party. The variable interest payments typically are tied to changes in the LIBOR or a United States Treasury rate. For example, assume Utility A plans to issue \$100 million of bonds payable in 20 years, and it also desires to limit its exposure to changes in interest rates. Utility A finds that the cost to issue the bonds at a fixed rate of interest exceeds the cost to issue variable interest 20-year bonds plus the cost to enter into an interest rate swap with Counterparty B where Utility A agrees to pay Counterparty B a fixed stream of interest payments for 20 years based on a \$100 million notional amount and Counterparty B agrees to pay Utility A stream of interest payments based on a \$100 million notional amount that varies periodically with changes in LIBOR. In this scenario, by issuing the variable interest bonds and negotiating an interest rate swap with Counterparty B, Utility A can effectively achieve its objective - to pay interest at a fixed rate and reduce its costs compared to issuing fixed interest bonds. Thus, a financial derivative is used to reduce interest rate risk and exposure and to reduce costs. The interest rate swap established a fixed net payment in interest rates, and it protects Utility A from interest rate increases and causes it to pay more interest if interest rates decrease.

However, by executing the interest rate swap, Utility A in the example above created a credit exposure – the possibility that Counterparty B will default on its variable interest payments to Utility A. Utility A could enter into yet another financial derivative, a credit default swap, and pay a periodic protection fee to a third party to mitigate this credit exposure. Utility A will also incur other financial costs related to issuing derivatives, e.g., payroll and overhead costs for financial, legal and other personnel to manage its derivatives.¹⁷

Management of financial derivatives also has non-financial implications. For example, it adds to the plethora of issues that the Company must manage and could detract from management's ability to focus on its core business activities.

Use of derivatives for managing risk differs as it pertains to interest rates than for energy transactions. In the case of energy transactions, derivatives address costs that typically vary widely in short periods and are passed through to ratepayers via an adjustor mechanism that provides a true-up of the costs incurred with the revenues collected from ratepayers. Quite differently, interest costs are only measured and included in rates during rate cases which often occur years apart.

The market for debt instruments is reasonably robust and competitive. Competition among lenders results in fixed and floating/variable debt instruments having similar costs on a risk adjusted basis. While the interest rate on variable interest debt may initially be lower (and

¹⁷ In response to Staff data requests 4.6 and 4.7, APS notes that it has established internal controls to prevent and detect errors and improprieties for derivative contracts pertaining to Energy Derivative Transacting, and that it anticipates developing and implementing appropriate controls regarding the management of interest rate risk and exposure through derivative or swap agreements if granted the requested approvals related to those financial instruments prior to execution of any such agreements.

thus more attractive) than the interest rate on fixed interest debt, the variable interest debt presents greater exposure to risk in the form of higher interest rates. That is, financial instruments with floating/variable cost rates present financial risk (a probability of loss) and exposure (a possibility of loss). As noted earlier, the nature of providing utility service places a strong value on cost stability, and the adverse impacts from variable costs should be managed to recognize a preference for cost stability over the risks presented by issuing floating cost financial instruments.

Under a multi-year general authority to issue multi-billion dollars in securities, it is prudent to limit the risk and exposure of variable cost financial instruments to the Company and its ratepayers. Despite the reasonably competitive market for debt instruments, the most appropriate debt instrument available to a utility at any time may be a variable debt instrument. Accordingly, Staff concludes that the aggregate outstanding value of floating cost long-term debt threshold that the Commission authorizes for APS should not exceed \$750 million. For purposes of calculating the aggregate outstanding balance of floating cost financing, any fixed cost security effectively converted to a floating cost security by issuance of a financial derivative instrument or any other means shall be deemed a floating cost security. Further, Staff concludes that the Commission should not grant APS authorization to enter into any derivative financial instrument that effectively converts a long-term fixed cost security into a long-term floating cost security, nor should the Company enter into any such agreement without Commission authority. To the contrary, Staff concludes that APS should be granted authority to enter into derivative financial instruments that convert floating cost long-term securities to long-term fixed cost securities. For purposes of calculating the aggregate outstanding balance of floating cost financing, any floating cost security effectively converted to a fixed cost security by issuance of a financial derivative instrument or any other means shall be deemed a fixed cost security.

Staff further concludes that there should be no predetermination that any gain or loss pertaining to fixed-to-floating or floating-to-fixed interest rate transactions or other financial derivative instruments or similar contracts used to manage interest rate risk and/or exposure will be reflected in the net interest rate of the financing instruments to which those transactions relate and, instead, that such determination should be deferred to a rate case. Staff further concludes that prior to initiation of trading activity in financial derivative securities or similar contracts to manage interest rate risk and/or exposure, APS be required to file confirmation with the Commission Docket Control Center certifying that it has established an appropriate management policy/system of internal controls formally approved by APS' Board of Directors designed to govern such trading within the organization. Staff further concludes that any authorization granted APS to engage in financial derivative securities or similar contracts to manage interest rate risk and/or exposure should specifically exclude use of such authorization for speculation.

Interest rate swap agreements and U.S. Treasury rate-lock agreements become an integral component of debt issuances, and it is in the public interest to control the use of these financial instruments. Assume a scenario whereby the Commission would approve a fixed interest rate loan, but would deny approval of a floating rate loan. If APS can enter into interest rate swap agreements without Commission authorization, the Company could circumvent the

Commission's wishes by applying for a fixed rate loan and, then, subsequent to receiving approval of the fixed rate debt, enter into an interest rate swap to effectively convert the loan to a floating interest rate loan in spite of the Commission's intention. Accordingly, Staff concludes that any general authorization granted to APS to issue long-term debt under a threshold should be subject to conditions that effectively control the Company's use of derivative financial instruments.

Declaratory Accounting Order

As presented above, APS requests a declaratory order confirming that all impacts of consolidation, for financial reporting purposes, of the Palo Verde Sale Leaseback Lessor Trusts ("VIEs") with APS are to be excluded, for purposes of calculating both the Common Equity Test and DSC, as well as from dollar limitations placed on all requested authorizations of indebtedness in this docket. APS asserts that, pursuant to a 2010 change in GAAP, APS is now required to consolidate these entities as debt in its financial statements, even though APS has no debt or equity interest in the VIEs and does not exercise control over them.

In its prior financing docket, APS requested, and was denied, a declaratory order seeking to confirm that only traditional indebtedness for borrowed money constitutes an evidence of indebtedness under A.R.S. §§ 40-301 and 40-302. However, Staff agreed with APS that a change in GAAP could have unintended consequences should APS exceed its authorized debt limits solely as a consequence of said GAAP change. Accordingly, to avoid any unintended collateral effects a prospective change in GAAP may have on APS' ability to issue debt previously authorized by the Commission, the ordering language in Decision No. 69947 contained a provision whereby any contract or other legally-binding arrangement to which APS is or becomes a party to will not be considered indebtedness for purposes of the Company's long-term debt, short-term debt, Common Equity Test and DSC if a change in GAAP subsequently occurs resulting in the obligation being considered indebtedness for purposes of GAAP. As contemplated in the ordering language noted above, the 2010 change in GAAP requiring APS to consolidate the VIEs for financial reporting purposes constitutes such a change.¹⁸ For the reasons noted above, Staff supports APS' request for a declaratory order regarding VIEs.

Conclusions and Recommendations

Staff concludes that incurrence of the short-term and long-term debt for which APS requests authorization, as modified by Staff, is within its corporate powers, is compatible with the public interest, would not impair its ability to provide services and would be consistent with sound financial practices if subsequent to any debt issuance (1) common equity represents at

¹⁸ As per the ordering language, a 30 day notification period was provided for within which APS was to both notify the Commission of the relevant change in GAAP and to file an application with the Commission requesting a decision as to whether such reclassified obligation should be included, or excluded, from debt. APS made no filing at the time the 2010 GAAP change took effect. In response to Staff data request 1.5, the Company stated it considered the provision to be permissive, and not mandatory. Staff agrees with that interpretation.

least 40 percent of total equity (common equity, preferred stock, long-term debt and short-term debt) and (2) debt service coverage ratio ("DSC") is equal to or greater than 2.0.¹⁹

Staff further concludes that:

1. The projects and related expenditure levels included in APS' 2012-2016 construction work plan appear to be reasonable; and
2. It is in the public interest for the Commission to have regulatory oversight of the use by APS of interest rate swap agreements, U.S. Treasury rate-lock agreements, derivative financial securities and similar instruments

Staff recommends adoption of an Order that includes language similar to that of Decision No. 69947 modified to reflect the following:

1. Increasing APS' authorized long-term debt threshold to \$5.1 billion subject to the following conditions:
 - (a) common equity represents at least 40 percent of total capital (common equity, preferred stock, long-term debt and short-term debt);
 - (b) debt service coverage ratio ("DSC") is equal to or greater than 2.0;
 - (c) variable interest debt should not exceed \$750 million; and
 - (d) APS not having entered into any agreement/contract for any financial derivative security or similar instrument other than those authorized by the Commission, and establishing that violation of this condition shall result in immediate expiration of this general authorization to issue long-term indebtedness (This provision is not intended to place any restriction on hedging activities pertaining to energy procurement).
2. That the authorizations to incur long-term debt, and short-term debt obligations provided in this proceeding replace all existing authorizations and that all existing authorizations expire upon the effective date of the authorizations provided in this proceeding.
3. Authorization for APS to incur short-term debt not to exceed \$500 million above 7 percent of total capital provided that the excess over 7 percent of total capital shall be used solely for costs relating to natural gas or power purchases and as long as APS has an authorized adjustor mechanism for recovery of these kinds of costs.
4. That short-term debt in excess of 7 percent of total capital, used solely for costs relating to natural gas or power purchases, not be applied toward APS' long-term debt threshold even when the amount remains outstanding for more than 12 months.

¹⁹ DSC for this purpose is calculated as operating income plus depreciation and amortization and income tax divided by interest and principle on short-term and long-term debt less short-term debt and interest related to purchased power and natural gas and using the most recent audited financial statements adjusted to reflect changes to outstanding debt.

5. Authorization for APS to redeem, refinance, refund, renew, reissue, roll-over, repay, and re-borrow from time to time the long-term debt and short-term debt in (1) and (3) above.
6. That the short-term and long-term debt levels authorized in this proceeding expire on December 31, 2016.
7. Authorization for APS to (1) conduct the activities enumerated in the application that are necessary to secure and maintain debt, (2) to determine the form of security (except as otherwise established in the Order), if any, for the continuing long-term debt and continuing short-term debt, execute and deliver the security instruments, and establish and amend the terms and provisions of the security instruments, as may be deemed appropriate by APS in connection with the continuing long-term debt and continuing short-term debt.
8. Denial of APS' request to issue Other Long-Term Securities..
9. Direct APS not to enter into any derivative financial instrument that effectively converts fixed cost long-term debt in (1) above to floating/variable cost debt;
10. Direct that for purposes of calculating the \$750 million aggregate limit on the outstanding balance of floating/variable cost rate long-term debt, in the event that the Commission authorizes issuance of derivative financial instruments that effectively convert fixed cost rate debt to floating cost rate debt, the converted debt shall be considered floating cost rate debt;
11. Authorize APS to enter into derivative financial instruments that convert floating cost long-term securities to long-term fixed cost securities. For purposes of calculating the \$750 million aggregate limit on the outstanding balance of floating/variable cost rate debt, any floating cost security effectively converted to a fixed cost security by issuance of a financial derivative instrument or any other means shall be deemed a fixed cost security;
12. Find that it is in the public interest for the Commission to control the use by APS of interest rate swap agreements, U.S. Treasury rate-lock agreements, derivative financial securities and similar instruments;
13. Require APS to file confirmation with the Commission Docket Control Center certifying that it has established an appropriate management policy/system of internal controls formally approved by APS' Board of Directors designed to govern such trading within the organization prior to initiation of trading activity in financial derivative securities or similar contracts to manage interest rate risk and/or exposure;

14. Find that any authorization granted APS to engage in financial derivative securities or similar contracts to manage interest rate risk and/or exposure should specifically exclude use of such authorization for speculative purposes;
15. Authorize APS to issue forward-starting swaps based on LIBOR or U.S. Treasuries and U.S. Treasury rate-locks for the purpose of hedging changes in interest rates up to 18 months in advance of planned issuances of fixed-rate taxable long-term debt having final maturity of five years or longer;
16. Deny APS' request to amortize gains or losses associated with pre-issuance interest rate hedging transactions over the life of the new debt issuance to which they relate;
17. Order that the authorizations to incur short-term and long-term debt obligations in this case shall replace all existing authorizations for the incurrence of short-term and long-term debt provided for in Decision No. 69947. that those authorizations expire upon the effective date of an Order in this case, and that all existing obligations incurred under lawful authorizations shall remain valid;
18. That on each occasion when APS enters into a new long-term debt agreement that APS file with the Commission's Docket Control Center within 90 days of the completion of the transaction a description of the transaction and a demonstration that the rates and terms were consistent with those generally available to comparable entities at the time and provide the Utility Division Compliance Section a copy of the relevant agreements; and
19. Approval of APS' request for a declaratory order confirming that all impacts of the consolidation with APS for accounting purposes of the Palo Verde Sale Leaseback Lessor Trusts as Variable Interest Entities ("VIEs") are to be excluded for the purpose of calculating Common Equity Test and DSC, and similarly excluded from calculating any dollar limits placed on authorizations for long-term debt and short-term debt.

MEMORANDUM

TO: John Cassidy
Public Utility Analyst
Utilities Division

FROM: Prem Bahl *PKB*
Electric Utilities Engineer
Utilities Division

DATE: October 22, 2012

SUBJECT: ARIZONA PUBLIC SERVICE COMPANY FINANCING APPLICATION
DATED NOVEMBER 22, 2011; DOCKET NO. E-01345A-11-0423

On November 22, 2011, Arizona Public Service Company ("APS" or "Company") submitted an application to the Arizona Corporation Commission ("Commission") requesting authorization to:

- (1) Increase APS' long-term indebtedness threshold¹, as set forth in the 2007 Order (Decision No. 69947), from \$4.2 billion to \$5.5 billion; and
- (2) Continue the existing authorization of Continuing Short Term Debt granted in the 2007 Order².

The proposed increase in long-term indebtedness will generally be utilized to fund APS' capital construction program over the six-year period, 2012-2017 and the short term indebtedness authorization will generally be utilized to meet seasonal and fluctuating working capital requirements. The requested long-term indebtedness is directly related to the growth of APS and the associated requirements to build new and upgrade existing electric system infrastructure. This Engineering Staff Report will, therefore, focus on APS' load and customer growth, customer reliability and capital construction program and address if the proposed long term debt authorization is reasonable and appropriate from an engineering perspective. However, because APS did not provide justification for the \$425 million of capital expenditures projected for the year 2017, Staff's engineering analysis of APS' capital construction program is confined to the five-year period, 2012-2016.

¹ As contemplated in the application, this would consist of both Continuing Long-Term Debt and Other Long-Term Securities.

² Docket No. E-01345A-06-0779

Utility Overview

APS is the principal subsidiary of Pinnacle West Capital Corporation and provides electric service to over 1 million Arizona customers in a 34,646 square mile area in all or part of 11 of Arizona's 15 counties. APS owns and maintains more than 33,000 miles of transmission and distribution lines and underground cable.

APS generation located in Arizona and New Mexico provided 6,344 MW in 2011, primarily from natural gas capacity of 3,389 MW (53%), coal capacity of 1753 MW (28%), followed by nuclear capacity of 1,146 MW (18%) and other (basically renewable resources) of 56 MW (1%). APS is the operating agent for the Palo Verde Nuclear Generating Station ("Palo Verde") as well as two coal-fired plants and six natural gas plants.

Load and Customer Growth for APS

APS has experienced an annual average peak load growth rate of approximately 2.4 percent in the last ten years, 2002-2011, however, in 2007, the demand dropped by 1.4 percent, and in 2008, the demand dropped by 6.9 percent and again in 2010 by 3.9 percent, apparently due to depressed economic conditions (see Exhibit PB-1). This average annual load growth tracked the customer average annual growth rate of 2.4 percent for the same time period (see Exhibit PB-2). It is noted from Exhibit PB-2 that the customer growth rate dropped considerably in 2008 to 1.4 percent, and to less than 1 percent in 2009-2011. Such a drop is attributed to loss of jobs and reduced influx of people and industries into Arizona from other states.

According to APS Integrated Resource Plan ("IRP") filing on March 30, 2012³, the Company is projecting an average annual load growth rate of 3 percent for the 2012-2021 time period. This again tracks APS' projection of an overall customer annual average growth rate of approximately 3 percent in the 2012-2021 time period (see Exhibit PB-3).

Customer Reliability

The Staff has adopted a North American Reliability Council ("NERC") definition of reliability. Reliability is comprised of two components: adequacy and security. Adequacy is the ability of an electric system to supply the aggregate electrical demand and energy requirements of its customers at all times, taking into account scheduled and reasonably expected unscheduled outages of system elements. Security is the ability of an electric system to withstand sudden disturbances such as electric short circuits or unanticipated loss of system elements.

Most major utilities use numerical indices as a measure of an average customer's distribution service reliability. Such reliability indices are typically computed on an annual basis. A utility may then set reliability targets based upon benchmarked data from its own system. The Institute of Electrical and Electronic Engineers ("IEEE") has adopted a standard definition for several reliability indices for electric distribution systems and established a

³ Docket No. E-00000A-11-0113

national benchmark database via a 2012 IEEE survey of the electric utility industry. The most commonly used reliability indices are System Average Interruption Frequency Index (“SAIFI”), System Average Interruption Duration Index (“SAIDI”), Customer Average Interruption Duration Index (“CAIDI”) and Momentary Average Interruption Frequency Index (“MAIFI”). These indices, except MAIFI, can be measured for service interruption of more than five minutes duration with or without major event days (“MED”). MEDs represent extreme conditions of outages, such as storms, etc.

MAIFI is measured for outages lasting five minutes or less. The MAIFI statistic is a lesser used measure in the industry as it is not indicative of longer outages; however, it does measure an “annoyance factor” with customers when short interruptions are excessive causing the frequent resetting of many electronic devices in the home or business.

In response to a data request from Staff, APS provided the values of the above noted reliability indices without MEDs for the last three years as indicated in Table 1 below.

Table 1
APS Distribution Reliability Indices 2009-2012

2009 IEEE MEDs Excluded					
N _T	1,114,529				
CI	982,583	SAIFI	0.88		
CMI (hr.)	1,347,316	SAIDI (hr.)	1.21	CAIDI (hr.)	1.37

2010 IEEE MEDs Excluded					
N _T	1,116,274				
CI	1,031,731	SAIFI	0.92		
CMI (hr.)	1,472,021	SAIDI (hr.)	1.32	CAIDI (hr.)	1.43

2011 IEEE MEDs Excluded					
N _T	1,116,274				
CI	897,356	SAIFI	0.80		
CMI (hr.)	1,329,265	SAIDI (hr.)	1.19	CAIDI (hr.)	1.48

These reliability indices are calculated based on the following formulas.

$$\text{SAIFI} = \text{CI} / \text{N}_T$$

$$\text{SAIDI} = \text{CMI (hr.)} / \text{N}_T$$

$$\text{CAIDI} = \text{SAIDI} / \text{SAIFI} \text{ or } = \text{CMI (hr.)} / \text{CI}$$

Where, N_T = Total Number of Customers served for the areas
CI = Customers Interrupted
CMI = Customer Minutes Interrupted

The average values of these indices in the 2009-2012 period are:

SAIFI	0.90
SADI	1.24 hr.
CAIDI	1.43 hr.

These values are satisfactory, as Staff understands that these reliability indices compare well with industry average values as they fall in the top quartile according to IEEE survey included in its 2012 guidelines. One of the reasons for these satisfactory results is that APS has been constantly improving and upgrading its Distribution Outage Management System (“DOMS”) for the past few years.

Although there are obviously some variations in the measures in different parts of APS’ relatively large service territory due to a variety of factors, the aggregate measure is a reasonable indicator of overall reliability. Additionally, these APS measures in Table 1 exclude MEDs generally associated with major storms and scheduled outages generally associated with maintenance or construction work activities pre-arranged to minimize customer impact. This adjustment provides a fairer outside comparison to the IEEE 2012 data which was not collected with the degree of specificity to differentiate all outages included in the IEEE survey.

APS Construction Work Plan for 2012 through 2016

APS has provided documentation supporting the projected five-year capital budget expenditures with itemization by classes as noted in the following Table 2.

Table 2

APS Total Capital Budget Expenditures 2012-2016

	2012	2013	2014	2015	2016	Total
Generation	755,822	698,671	607,805	767,081	637,884	3,467,263
Transmission	108,197	169,467	193,223	189,201	80,150	740,238
Sub-Transmission	41,440	41,695	28,676	74,611	41,937	228,359
Distribution	244,701	248,656	231,265	317,035	311,995	1,353,652
Underground Cable	26,194	22,511	19,030	22,508	22,869	113,112
Total	1,176,354	1,181,000	1,079,999	1,370,436	1,094,835	5,902,624

APS has the responsibility to make prudent infrastructure investment to ensure reliable and cost effective electric service to its customers. Staff has selectively reviewed a number of capital projects included in the APS 2012-2016 Construction Work Plan and finds the projects appropriate and their associated costs reasonable. Staff has no position and makes no recommendation on these expenditures for prudence or ratemaking purposes.

Conclusions and Recommendations

Based on the review of APS' anticipated load and customer growth, customer reliability statistics and 2012-2016 Construction Work Plans, it is Staff's conclusion that:

1. The load and customer growth rates of APS are reasonably projected based on past load and customer growth rates and overall population growth expected for Arizona.
2. The customer reliability measures for the last three years on an aggregate system basis indicate APS is managing its distribution system on a comparable par with the other similar utilities in the nation with regard to reliability. It is Staff's recommendation that APS continue this trend with continued emphasis on reliability and appropriate infrastructure investment.
3. APS is making investment in its capital plant over the next five years in a manner that indicates new customers will be adequately and timely served and all customers can expect a reasonable level of reliability. APS' 2012-2016 Construction Work Plan is appropriate and the associated capital expenditure levels shown in Table 2 appear reasonable. However, this does not imply a specific treatment or recommendation for rate base or rate making purposes in APS' future rate filings.

EXHIBIT PB-1

APS System Annual Peak Load 2002-2011

<u>Year</u>	<u>MW</u>	<u>% Annual Change</u>
2002	5,803	
2003	6,332	9.1%
2004	6,402	1.1%
2005	7,000	9.3%
2006	7,652	9.3%
2007	7,545	-1.4%
2008	7,026	-6.9%
2009	7,218	2.7%
2010	6,936	-3.9%
2011	7,087	2.2%
% Average Annual Change 2002-2011		2.4%

Exhibit PB-2

Number of APS Customers 2002-2012

By Customer Class

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	% Delta Average
Residential	801,801	828,366	859,069	896,472	936,464	966,013	977,944	983,539	989,989	994,244	
<i>% delta year over year</i>		3.2%	3.6%	4.2%	4.3%	3.1%	1.2%	0.6%	0.7%	0.4%	2.4%
Commercial	95,575	98,424	102,393	106,374	110,547	115,304	118,945	120,305	120,372	121,116	
<i>% delta year over year</i>		2.9%	3.9%	3.7%	3.8%	4.1%	3.1%	1.1%	0.1%	0.6%	2.6%
Industrial and Irrigation	3,671	3,681	3,730	3,794	3,871	3,927	3,933	3,857	3,784	3,744	
<i>% delta year over year</i>		0.3%	1.3%	1.7%	2.0%	1.4%	0.2%	-2.0%	-1.9%	-1.1%	0.2%
Public Street Lighting and Public Authorities	982	988	993	1,000	1,013	1,083	1,083	1,080	1,164	1,132	
<i>% delta year over year</i>		0.6%	0.5%	0.7%	1.3%	6.5%	0.0%	-0.3%	7.2%	-2.8%	1.5%
TOTAL											
	902,029	931,459	966,185	1,007,640	1,051,895	1,086,327	1,101,905	1,108,781	1,115,309	1,120,236	
<i>% delta year over year</i>		3.2%	3.6%	4.1%	4.2%	3.2%	1.4%	0.6%	0.6%	0.4%	2.4%

*Data is from FERC Form 1 Pg. 304 for years 2002-2011

Exhibit PB-3

**APS
Projected Retail Customers
2012-2021**

<u>Year</u>	<u>Customers</u>	<u>% Annual Change</u>
2012	1,129,805	
2013	1,147,321	1.6%
2014	1,174,786	2.4%
2015	1,212,050	3.2%
2016	1,254,425	3.5%
2017	1,298,396	3.5%
2018	1,342,147	3.4%
2019	1,385,311	3.2%
2020	1,428,067	3.1%
2021	1,469,926	2.9%
% Average Annual Change 2012-2021		3.0%



ORIGINAL

ATTACHMENT B

0000140161

JOHNSON
Jirs Supervisor

State Regulation

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Jeffrey.Johnson@aps.com

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AZ CORP COMMISSION
DOCKET CONTROL

October 23, 2012

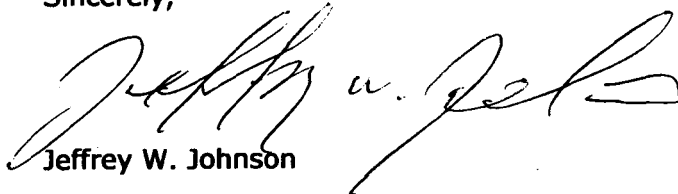
Docket Control
Arizona Corporation Commission
1200 W. Washington
Phoenix, AZ 85007

RE: Arizona Public Service Company's Finance Application
Docket No. E-01345A-11-0423

Arizona Public Service Company ("APS") hereby states that the attached copy of Public Notice was published within APS' service territory, which ran in the Arizona Republic on October 16, 2012. Attached are copies of the notices and affidavits of publication.

If you have any questions regarding this information, please contact Zachary Fryer at (602)250-4167.

Sincerely,



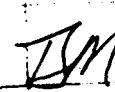
Jeffrey W. Johnson

JJ/cd

cc:

Arizona Corporation Commission
DOCKETED

OCT 23 2012

DOCKETED BY 

**PUBLIC NOTICE OF AN APPLICATION
FOR ORDERS AUTHORIZING ARIZONA
PUBLIC SERVICE COMPANY TO ISSUE,
INCUR, AND AMEND EVIDENCES OF
LONG-TERM INDEBTEDNESS, SHORT-TERM
INDEBTEDNESS, AND OTHER LONG-TERM
SECURITIES, TO MANAGE INTEREST
RATE RISK, TO EXECUTE NEW SECURITY
INSTRUMENTS TO SECURE ANY SUCH
INDEBTEDNESS OR OTHER LONG-TERM
SECURITIES, AND FOR DECLARATORY
ORDER CONCERNING VARIABLE
INTEREST ENTITIES**

Arizona Public Service Company (Company) filed an Application with the Arizona Corporation Commission (Commission) for an order authorizing the Company to issue long-term debt up to a "cap" of \$5.5 billion and short-term debt up to a "cap" equaling the sum of 7% of the Company's capitalization plus \$500 million. The application further seeks authority to issue Other Long-Term Securities, as defined therein, and for declaratory relief relative to Variable Interest Entities. The application is available for public inspection during regular business hours at the Company's offices at 400 North 5th Street in Phoenix, Arizona, the Commission's Docket Control Center at 1200 West Washington in Phoenix, Arizona, and on the Internet via the Commission's website (www.azcc.gov) using the e-Docket function, located at the bottom of the webpage, in Docket No. E-01345A-11-0423.

Intervention in the Commission's proceedings on the application shall be permitted to any person entitled by law to intervene and having a direct substantial interest in this matter. Persons desiring to intervene must file a Motion to Intervene with the Commission which must be served upon applicant and which, at a minimum, shall contain the following information:

1. The name, address and telephone number of the proposed intervenor and of any person upon whom service of documents is to be made if different than the intervenor.
2. A short statement of the proposed intervenor's interest in the proceeding.
3. Whether the proposed intervenor desires a formal evidentiary hearing on the application and the reason for such a hearing.
4. A statement certifying that a copy of the Motion to Intervene has been mailed to Applicants.
5. The granting of Motions to Intervene shall be governed by A.A.C. R14-3-105, except that all Motions to Intervene must be filed within 15 days after the date of this notice.

THE ARIZONA REPUBLIC

STATE OF ARIZONA
COUNTY OF MARICOPA } SS.

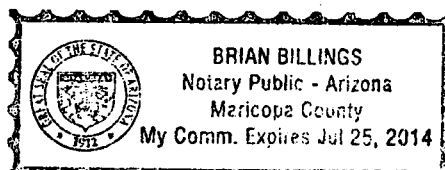
Tabitha Weaver, being first duly sworn, upon oath deposes and says: That she is a legal advertising representative of the Arizona Business Gazette, a newspaper of general circulation in the county of Maricopa, State of Arizona, published at Phoenix, Arizona, by Phoenix Newspapers Inc., which also publishes The Arizona Republic, and that the copy hereto attached is a true copy of the advertisement published in the said paper on the dates as indicated.

The Arizona Republic

10/16/2012



Sworn to before me this
22nd day of
October A.D. 2012


Notary Public